April 13, 2016

Putting the MetLife Decision into an Economic Context

In a recently released decision, a U.S. district court has ruled that the Financial Stability Oversight Council's (FSOC's) decision to designate MetLife as a potential threat to financial stability was "arbitrary and capricious" and rescinded that designation. This decision raises many questions, among them:

- Why did MetLife sue to end its status as a too-big-to-fail (TBTF) firm?
- How will this decision affect the Federal Reserve's regulation of nonbank financial firms?
- What else can be done to reduce the risk of crisis arising from nonbank financial firms?

Why does MetLife want to end its TBTF status?
An often-expressed concern is that market participants will consider FSOC-designated firms too big to fail, and investors will accord these firms lower risk premiums (see, for example, Peter J. Wallison). The result is that FSOC-designated firms will gain a competitive advantage. If so, why did MetLife sue to have the designation rescinded? And why did the announcement of the court's determination result in an immediate 5 percent increase in the MetLife's stock price?

One possible explanation is that the FSOC's designation guarantees the firm will be subject to higher regulatory costs, but it only marginally changes the likelihood it would receive a government bailout. The Dodd-Frank Act (DFA) requires that FSOC-designated firms be subject to consolidated prudential supervision by the Federal Reserve using standards that are more stringent than the requirements for other nonbank financial firms.

Moreover, the argument that such designation automatically conveys a competitive advantage has at least two weaknesses. First, although Title II of the DFA authorizes the Federal Deposit Insurance Corporation (FDIC) to resolve a failing nonbank firm in certain circumstances, DFA does not provide FDIC insurance for any of the nonbank firm's liabilities, nor does it provide the FDIC with funds to undertake a bailout. The FDIC is supposed to recover its costs from the failed firm's assets. Admittedly, DFA does allow for the possibility that the FDIC would need to assess other designated firms for part of the cost of a resolution. However, MetLife could as easily have been assessed to pay for another firm as it could have been the beneficiary of assessments on other systemically important firms.

A second potential weakness in the competitive advantage argument is that the U.S. Treasury Secretary decides to invoke FDIC resolution only after receiving a recommendation from the Federal Reserve Board and one other federal financial regulatory agency (depending upon the type of failing firm). Invocation of resolution is not automatic. Moreover, a part of any decision authorizing FDIC resolution are findings that at the time of authorization:

- the firm is in default or in danger of default,
- resolution under other applicable law (bankruptcy statutes) would have "serious adverse consequences" on financial stability, and
- those adverse effects could be avoided or mitigated by FDIC resolution.

Although it would seem logical that FSOC-designated firms are more likely to satisfy these criteria than other financial firms, the Title II criteria for FDIC resolution are the same for both types of firms.

How does this affect the Fed's regulation of nonbank firms?
Secretary of the Treasury Jack Lew has indicated his strong disagreement with the district court's decision, and the U.S. Treasury has said it will appeal. Suppose, however, that FSOC designation ultimately does become far more difficult. How significantly would that affect the Federal Reserve's regulatory power over nonbank financial firms?

Although the obvious answer would be that it would greatly reduce the Fed's regulatory power, recent experience casts some doubt on this view. Nonbank financial firms appear to regard FSOC designation as imposing costly burdens that substantially exceed any benefits they receive. Indeed, GE Capital viewed the costs as so significant that it had been selling large parts of its operations and recently petitioned the FSOC to rescind its designation. Unless systemically important activities are a core part of the firm's business model, nonbank financial firms may decide to avoid undertaking activities that would risk FSOC designation.

Thus, a plausible set of future scenarios is that the Federal Reserve would be supervising few, if any, nonbank financial firms regardless of the result of the MetLife case. Rather, ultimate resolution of the case may have more of an impact on whether large nonbank financial firms conduct systemically important activities (if designation becomes much harder) or the activities are conducted by some combination of smaller nonbank financial firms and by banks that are already subject to Fed regulation (if the ruling does not prevent future designations).

Lessons learned?
Regardless of how the courts and the FSOC respond to this recent judicial decision, the financial crisis should have taught us valuable lessons about the importance of the nonbank financial sector to financial stability. However, those lessons should go

beyond merely the need to impose prudential supervision on any firms that are systemically important.

The cause of the financial crisis was not the failure of one or two large nonbank financial firms. Rather, the cause was that almost the entire financial system stood on the brink of collapse because almost all the major participants were heavily exposed to the weak credit standards that were pervasive in the residential real estate business. Yet if the real problem was the risk of multiple failures as a result of correlated exposures to a single large market, perhaps we ought to invest more effort in evaluating the riskiness of markets that could have systemic consequences.

In an article in *Notes from the Vault* and other forums, I have called for systematic end-to-end reviews of major financial markets starting with the origination of the risks and ending with the ultimate holder(s) of the risks. This analysis would involve both quantitative analysis of risk measures and qualitative analysis of the safeguards designed to reduce risk.

The primary goal would be to identify and try to correct weaknesses in the markets. A secondary goal would be to give the authorities a better sense of where problems are likely to arise if a market does encounter problems.

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April 13, 2016 in Banking, Regulation | Permalink